Supreme Court, U.S.
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No. 97-973

In The

Supreme Court of the United States

October Term, 1997

JOHN A. COCHRANE,

Petitioner,

vs.

TUDOR OAKS LIMITED PARTNERSHIP,

Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

RESPONDENT'S BRIEF IN OPPOSITION

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STATEMENT OF THE CASE

This is a petition from an order of the Eighth Circuit Court of Appeals affirming a summary judgment order which found that a debt of the Petitioner to the Respondent was non-dischargeable in his bankruptcy. The debt arises from a State Court Judgment.

The following facts are based upon the findings of the jury in the State Court action between the two parties ("State Court Action") and the facts as stated by the Minnesota Court of Appeals in the appeal of that decision. The Bankruptcy Court's decision and Eighth Circuit Court of Appeal's decision also concisely summarizes the facts. Much of the Petitioner's Statement of the Case are "facts" which were not found by any Court and, actually, were rejected.

Tudor Oaks Limited Partnership ("Tudor Oaks" or "Respondent") retained the Petitioner to represent it for a $20,000 fee in a lawsuit commenced against the Respondent by First Bank Minnesota, N.A. involving a foreclosure on certain real estate and any deficiency amount arising after the foreclosure sale. (*See* Court of Appeals decision, a copy of which is included in Petitioner's Appendix at Apdx. 101.) The Petitioner then arranged for several investors, including himself, to purchase the Sheriff's Certificate at the foreclosure sale on that same real estate for $1.2 million. (Court of Appeals decision, Petitioner's Appendix at Apdx. 101.) The Respondent and the Petitioner agreed that the Petitioner would retain a twenty percent (20%) interest in the property as a fee for arranging the purchase. (Court of Appeals decision, Petitioner's Appendix at Apdx. 101.) Sixty percent (60%) of the property was purchased by KSCS Properties, Inc., of which Petitioner was a one-quarter (1/4) shareholder. (Court of Appeals decision, Petitioner's Appendix at Apdx. 101.) The Petitioner and his three partners

contributed $300,000 for the sale. (Court of Appeals decision, Petitioner's Appendix at Apdx. 101.) The remaining twenty percent (20%) was expected to be transferred to the Respondent. (Court of Appeals decision, Petitioner's Appendix at Apdx. 101.) Instead, the twenty percent (20%) interest was put in the name of two of the KSCS shareholders, Roland Stinski and Bill Keifer, Sr. (Court of Appeals decision, Petitioner's Appendix at Apdx. 101.)

The Respondent then sued the Petitioner for breach of fiduciary duty for: (1) taking the twenty percent (20%) interest in the property as a fee for finding purchasers; (2) purchasing an undisclosed fifteen percent (15%) interest in the property through the Petitioner's investment in KSCS; and (3) failing to represent the Respondent by permitting KSCS shareholders Stinski and Keifer to take the twenty percent (20%) interest expected to go to the Respondent. (Court of Appeals decision, Petitioner's Appendix at Apdx. 102.)

The Respondent prevailed at the trial in this matter. As a result of these breaches, judgment was entered in the amount of $1,628,000 (*See* Court of Appeals decision, Petitioner's Appendix at Apdx. 102.) The special verdict form shows the breaches of fiduciary duty. (A copy of the Special Verdict Form is included in Respondent's Appendix at 1a.)

The Petitioner appealed this decision. The Minnesota Court of Appeals affirmed the breach of fiduciary duty portion of the findings. The only change regarding the Respondent was that the damages were reduced from $1,628,000 to $1,256,666. The Respondent then sought to have the Order amended to include prejudgment interest and it was amended to include prejudgment interest of $465,339.52 as of April 11, 1994.

On December 22, 1992, the Petitioner filed for relief under Chapter 11 of Title 11 (bankruptcy) of the U.S. Code, and this

case was converted to Chapter 7 on February 15, 1994. This adversary proceeding, seeking an order finding that the debt of the Petitioner to the Respondent was non-dischargeable, was filed in a timely manner on May 20, 1994. The Petitioner answered the Complaint challenging the findings in the previous action.

The Petitioner also brought a lawsuit to vacate the judgment in State District Court in Minnesota. That State District Court lawsuit was dismissed. (A copy of the decision by the State District Court is at Apdx. 84 of the Petitioner's Appendix.) The Petitioner sought vacation of the judgment largely on the basis that it was obtained by fraud for failure to disclose the dissolution of the Respondent partnership. On that issue, Minnesota State District Judge Gary Larson found that the issue was irrelevant since,

> . . . even though Tudor Oaks did not have a right to maintain any action, the only remaining partner, S. B. McLaughlin had a right to continue the action commenced before the partnership dissolved.

(Petitioner's Appendix, at Apdx. 98.) It found that, as a matter of law, the fraud defense failed. The Minnesota Court of Appeals affirmed this decision. A copy of the Minnesota Court of Appeals opinion is at Apdx. 60 of Petitioner's Appendix. It is also published as *Cochrane v. Tudor Oaks Condominium Project*, 529 N.W. 2d 429 (Minn. App. 1995), *review denied*, (1995).

The Respondent moved for summary judgment in the Bankruptcy Court adversary proceeding on the basis of collateral estoppel. The Bankruptcy Court found that in this case the breach of fiduciary findings in the State Court could be applied to this action under the theory of collateral estoppel and that as to the standing issue (either under the theory of collateral estoppel or

as a matter of law) the action could be maintained by S.B. McLaughlin & Co., as liquidating trustee of Tudor Oaks Limited Partnership. The District Court affirmed the Bankruptcy Court order and the Eighth Circuit Court of Appeals affirmed the District Court. The Eighth Circuit found that the Respondent had standing as a matter of law, collateral estoppel applied, and the Petitioner committed a defalcation while acting in a fiduciary capacity. As a result, the debt was held non-dischargeable.

SUMMARY OF THE ARGUMENT

The Petitioner has presented four questions. The first question is whether a breach of fiduciary duty resulting in no damages can be a defalcation under 11 U.S.C. § 523(a)(4). There was a defalcation in this case and there were damages. The second and fourth questions addressed whether the Respondent has standing and whether collateral estoppel on the issue of standing applies. It is clear that the Respondent has standing as the remaining partner of a dissolved partnership. It is also clear that collateral estoppel was never applied by the Eighth Circuit Court of Appeals on this issue — it decided standing as a matter of law. Finally, the third question asked whether full, faith, and credit can be given to the state court proceeding when there are allegations the judgment was obtained by fraud. The Eighth Circuit Court of Appeals properly held that collateral estoppel did apply and the fraud argument failed as a matter of law. The standing, collateral estoppel, and defalcation issues will now be addressed.

REASONS FOR DENYING THE WRIT

I.

THE RESPONDENT HAS STANDING TO BRING THIS ACTION.

The Petitioner argues that the Respondent had no standing to bring this action. Assuming the Respondent is a dissolved partnership, it is clear that under Ontario law (the governing law) and the partnership agreement, the remaining partners of a dissolved partnership have the right to wind up the affairs of the partnership. Ontario Partnership Act Section 38 states,

> After the dissolution of a partnership, the authority of each partner to bind the firm and other rights and obligations of the partners continue despite the dissolution so far as is necessary to wind up the affairs of the partnership and to complete transactions begun but unfinished at the time of the dissolution, but not otherwise . . .

This was the finding of the State District Court and the Minnesota Court of Appeals. Accordingly, the only remaining partner, S.B. McLaughlin & Co. has a right to proceed in the Bankruptcy Court.

The Bankruptcy Court stated in footnote 17 of its Order at Apdx. 38-39 in the Petitioner's Appendix,

> Regardless of whether the named party-plaintiff is a valid, subsisting legal entity with capacity to sue or to be sued, its one remaining partner has the right under Ontario law to wind up its affairs and to continue litigation under its name to do so.

The Eighth Circuit agreed that the standing was a clear issue under Ontario law. It cited section 38 of the Ontario Partnership Act and held that ". . . McLaughlin has standing to litigate this bankruptcy matter in the name of Tudor Oaks." (Petitioner's Appendix at Apdx. 12.)

The Petitioner states in the fourth question presented that the standing ruling was made on the basis of collateral estoppel. In fact, the Eighth Circuit Court of Appeals specifically declined to apply collateral estoppel. (*See* Petitioner's Appendix at Apdx. 10.) Instead, it made this determination as a matter of Ontario law.

The assets, including a claim, do not disappear when a partnership is dissolved. The remaining partner or partners take control. It is that simple. The Petitioner never disputes this point; instead, he argues in pages 18-22 of his brief that the Respondent is a dissolved partnership. This issue is irrelevant because as the Bankruptcy Court and Eighth Circuit Court of Appeals correctly pointed out, the remaining partner, S.B. McLaughlin, may wind up the affairs of the dissolved partnership. The Respondent has standing as a matter of law.[1]

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1. The decision of *Appletree Square I Limited Partnership & Business Consultants, Inc. v. O'Connor & Hannon*, 559 N.W.2d 711 (Minn. App. 1997), *review granted*, (1997), cited by the Petitioner, has nothing to do with this case. That case involved a transfer of a malpractice claim and whether the transferee had standing to bring the claim. There was no transfer of a malpractice claim in this case. First, this is not a malpractice claim. Second, there was no transfer since the Respondent still has the breach of fiduciary duty claim.

II.

COLLATERAL ESTOPPEL APPLIES.

Under certain circumstances, a debt is not discharged by a bankruptcy. 11 U.S.C. § 523(a)(4) states that a debt which arises from a "defalcation while acting in a fiduciary capacity" is a non-dischargeable debt. The Bankruptcy Court correctly held that the findings of the State Court that the Petitioner breached his fiduciary duty to Respondent may be applied to this case by collateral estoppel for a finding that the debt is non-dischargeable as a defalcation by a fiduciary. *Johnson v. Miera* (*In re Miera*), 104 B.R. 150, 156 (Bankr. D. Minn. 1989), *affirmed*, 926 F.2d 741 (8th Cir. 1991). In this case there is no question that breach of fiduciary duty was determined in the prior action, was actually litigated, was determined by a valid and final judgment and was essential to that final judgment. Thus, collateral estoppel applies. (There is no longer any question that a state court action can have a collateral estoppel effect in a non-dischargeability action. *See Grogan v. Garner*, 498 U.S. 279, 111 S. Ct. 654, 112 L. Ed. 2d 755 (1991).)

When the Petitioner attacks the findings of the State Court action, he is trying to relitigate issues he has already lost. These findings, no matter how much the Petitioner disagrees with them, cannot be challenged. The Petitioner's attack on the Bankruptcy Court's findings in his brief is irrelevant. Further, the contents of Appendix E of his Appendix is irrelevant as an attack on the State Court Judgment.

The Petitioner further argues that the issue of whether the judgment in the State District Court Judgment was obtained by fraud was not "actually litigated," one of the requirements for collateral estoppel. The Petitioner argued that the dissolution of the Respondent was fraudulently concealed from him

precluding him from raising lack of standing as a defense. (Of course, the Respondent vigorously denies it fraudulently concealed the dissolution.)

This issue was litigated and the State District Court ruled against the Petitioner on this precise point on summary judgment. A trial was not necessary. In other words, the State Court ruled that, as a matter of law, the defense of fraud (for failure to disclose the partnership dissolution) failed. The State District Court had two reasons for granting summary judgment. First, the Petitioner waived this defense. (*See* Petitioner's Appendix at Apdx. 92). The court pointed out that if the dissolution had been disclosed by the Respondent and the Petitioner had raised the issue of standing, the Respondent could have simply filed fees to restore the limited partnership retroactively. (Petitioner's Appendix at Apdx. 97.) Further, its general partner could have restored its corporate status (which had lapsed). (Petitioner's Appendix at Apdx. 97.)

More importantly, the Court cited Ontario law (Ontario Partnership Act, section 38) and found:

> . . . even though Tudor Oaks did not have a right to maintain any action, the only remaining partner, S.B. McLaughlin had a right to continue the action commenced before the partnership dissolved.

(Petitioner's Appendix at Apdx. 98). The court held that even if the Respondent's dissolution was fraudulently concealed, it was irrelevant because S.B. McLaughlin could maintain the case in any event.

The Eighth Circuit agreed that the fraud issue had already been fully litigated and collateral estoppel applied. Therefore, the reason the Petitioner never had a chance to present evidence

in the State Court that the judgment was obtained by fraud was because the defense failed as a matter of law. The Petitioner did actually litigate those issues in the summary judgment proceedings and lost. Accordingly, collateral estoppel applies.

III.

THERE WERE DAMAGES IN THIS CASE.

The Petitioner's first question presented is whether a breach of fiduciary duty resulting in no damage can be a defalcation. However, there were damages caused by the breach of fiduciary duty. The jury found that the breach of fiduciary duty caused damages in the amount of $1,744,568.22 (as later amended). Again, the Petitioner may disagree that the breach of fiduciary duty caused this damage, but collateral estoppel bars him from questioning it. The breach of fiduciary duty did cause damage.

IV.

A DEFALCATION BY A FIDUCIARY DID OCCUR.

The Petitioner argues that no defalcation occurred. It is well established that fiduciary duties that arise constructively are not the type of fiduciary duty required under 11 U.S.C. § 523(a)(4). The Petitioner and Respondent have never disagreed on this point. The Bankruptcy Court and the Eighth Circuit Court of Appeals also reaffirmed this point. *See Davis v. Aetna Acceptance Co.*, 293 U.S. 328, 55 S. Ct. 151, 79 L. Ed. 393 (1934), the cases cited by the Petitioner at page 13-14 of the Petitioner's brief, and the cases in the Bankruptcy Court Order in the Petitioner's Appendix at Apdx. 29. An attorney-client relationship is probably one of the oldest and most recognized forms of fiduciary relationships and does not arise constructively since it exists prior to the "bad acts." Courts have consistently determined that this is the type of fiduciary relationship

recognized by 11 U.S.C. § 523(a)(4) for non-dischargeable purposes. *See In re Marchiando*, 13 F.3d 1111, 1115 (7th Cir. 1994), *cert. denied*, 512 U.S. 1205, 114 S. Ct. 2675, 129 L. Ed 2d 810 (1994) ("So a lawyer is deemed the fiduciary of his client, even if he does not manage a fund entrusted by the client. . . .") These cases hold that the attorney-client fiduciary relationship if breached, can lead to a non-dischargeable debt. *See Kartchner v. Kudla* (*In re Kudla*), 105 B.R. 985 (Bankr. D. Colo. 1989); *Federal Savings and Loan Insurance Corporation v. Mmahat* (*In re Mmahat*), 97 B.R. 293 (E.D. La. 1988), *affirmed in part and remanded*, 907 F.2d 546 (5th Cir. 1990), *cert. denied*, 499 U.S. 936, 111 S. Ct. 1387, 113 L. Ed. 2d 444 (1991) (an unrelated part of this holding involving banking law has been overruled); *Morales v. Codias* (*In re Codias*), 78 B.R. 344 (Bankr. S.D. Fla. 1987); *Schwalbe v. Gans* (*In re Gans*), 75 B.R. 474 (Bankr. S.D.N.Y. 1987); *Douchette v. Kwait* (*In re Kwait*); 62 B.R. 818 (Bankr. D. Mass. 1986), *affirmed in part and vacated in part*, 81 B.R. 184 (D. Mass. 1987); *Purcell v. Janikowski* (*In re Janikowski*), 60 B.R. 784 (Bankr. N.D. Ill. 1986); and *Brawer v. Gelman* (*In re Gelman*), 47 B.R. 735 (Bankr. S.D. Fla. 1985).

The Eighth Circuit Court of Appeals held that the breach of this fiduciary duty was a "defalcation" under 11 U.S.C. § 523(a)(4) and led to the damages. Defalcation is broadly defined and includes the taking of an opportunity that results in the damages to the party from whom it was taken. *See* Bankruptcy Court Order at Apdx. 35, *Pan-Western Life Insurance v. Galbreath* (*In re Galbreath*), 112 B.R. 892 (Bankr. S.D. Ohio 1990); *F.D.I.C. v. Sax* (*In re Sax*), *F.D.I.C. v. Sweeney* (*In re Sweeney*), 106 B.R. 534 (Bankr. N.D. Ill. 1989). For example, an attorney who arranged for improper loans from a bank was guilty of a defalcation. As stated in *F.D.I.C. v. Mmahat*, *supra*, 907 F.2d at 550,

> FDIC argues that there was defalcation: Mmahat . . . [the attorney] . . . urged Gulf Federal to make

> improper loans so that he could earn fees. Mmahat thereby enriched himself at the cost of Gulf Federal's assets. . . . We agree.

See also In re Moreno, 892 F.2d 417 (5th Cir. 1990) (corporate loans arranged for officer's benefit is defalcation). As in *Mmahat*, the Petitioner enriched himself at the expense of the Respondent. As stated by the Bankruptcy Court on Apdx. 37-38 of Petitioner's Appendix,

> It is clear that the Minnesota State Court's unadorned finding the Defendant had breached his fiduciary duty to the Plaintiff in three separate instances is sufficient to make out a "defalcation" within the contemplation of § 523(a)(4).

There is no support of any kind for the Petitioner's position that some type of "bad intent" must exist for a finding of defalcation. (In fact, he cites no support.) To the contrary, all courts have rejected the Petitioner's position. (*See* Bankruptcy Court Order, Petitioner's Appendix at Apdx. 36.) *See also Lewis v. Scott*, 97 F.3d 1182 (9th Cir. 1996).

The Petitioner argues that a defalcation requires a violation of an express trust "res" and that there is none in this case. He cites a Sixth Circuit decision, *Garver v. R.E. America, Inc.*, 116 F.3d 176 (6th Cir. 1997) which states that the fiduciary must actually take property from a trust "res" to commit a defalcation. The statements in that case could result in a definition of defalcation which is more narrow than the definition other courts have used. These cases, exemplified by the Bankruptcy Court order in this case, hold that a formal trust is not necessary. However, the debt must be an obligation which arises from a breach of the fiduciary duty and not other types of obligations. *See F.D.I.C. v. Mmahat*, 907 F.2d 546, 549-550 (5th Cir. 1990), *cert.*

denied, 499 U.S. 936 (1991) (attorney breached duty by advising bank to make bad loans from which he profited); *In re Janikowski*, 60 B.R. 784, 790 (Bankr. N.D. Ill. 1986) (attorney's failure to record deed is a breach of duty); *Pan Western Life Insurance v. Galbreath* (*In re Galbreath*), 112 B.R. 892 (Bankr. S.D. Ohio 1990) (corporate officer breached fiduciary duty by arranging improper loans); and *F.D.I.C. v. Sax* (*In re Sax*), *F.D.I.C. v. Sweeney* (*In re Sweeney*), 106 B.R. 534 (Bankr. D. Ill. 1989) (corporate officer breached duty by arranging for improper loans).

This view is also consistent with the statute, 11 U.S.C. § 523(a)(4), which does not discuss a trust or a trust "res"; it simply provides a debt resulting from defalcation while acting in a fiduciary capacity is not dischargeable. However, these cases, the Bankruptcy Court decision, and the Eighth Circuit decision do not hold that any debt owed by an attorney is not dischargeable, as the Petitioner claims. As pointed out by the Bankruptcy Court and by the opinion cited by the Petitioner, *Fowler Brothers v. Young* (*In re Young*), 91 F.3d 1367, 1372 (10th Cir. 1986), there must be a breach of a "trust relationship" between an attorney and a client to find a defalcation while acting in a fiduciary capacity. In this case, there is no question there was a breach of the trust relationship. This was not a simple debtor/creditor relationship as in *In re Young*, *supra* (a loan) because the breach resulted directly from the fiduciary relationship an attorney has to the client. First, there was a breach of fiduciary duty for taking the twenty percent (20%) interest in the property as a fee for finding purchasers. Second, there was a fiduciary duty breach for purchasing an undisclosed fifteen percent (15%) interest in the property through the Petitioner's investment in KSCS. And, third, there was a breach of fiduciary duty by permitting KSCS shareholders to take the twenty percent (20%) interest expected to go to the Respondent.

The Sixth Circuit's narrow definition is irrelevant to its holding since the *Garver* case did not involve a breach of the

trust relationship; it involved a mere creditor/debtor relationship, which is dischargeable under any test or definition of defalcation. The attorney in that case had breached a promise to invest funds and committed malpractice. Thus, *Garver* would be decided the same way under the test used by the Eighth Circuit and other courts because the debt did not result from a breach of the trust relationship.

In any event, even if the *Garver* statements were used as the defalcation definition, there was a "res" in this case because the opportunity to invest was held in trust by the Petitioner who misused it. The taking of the opportunity was no different from taking money out of a trust account. This case would have the same result in the Sixth Circuit. There is no split between the circuits on the issue of what constitutes a defalcation which must be resolved by this Court to decide this case.

CONCLUSION

For the reasons stated above, the Petitioner respectfully requests that the Court deny the petition.

Respectfully submitted,

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APPENDIX

APPENDIX A — SPECIAL VERDICT FORM

STATE OF MINNESOTA DISTRICT COURT
COUNTY OF HENNEPIN FOURTH JUDICIAL DISTRICT

File No. 87-11035

S.B. McLaughlin & Company, Ltd., Tudor Oaks Condominium Project, an Ontario Limited Partnership; ABIO Holdings (Minnesota) Inc., a Minnesota corporation

Plaintiffs,

vs.

John Cochrane, an individual, and KSCS Properties, Inc., a Minnesota corporation

Defendants.

SPECIAL VERDICT FORM

1. Did Mr. Cochrane breach a fiduciary duty to Tudor Oaks Condominium Project, an Ontario Limited Partnership with respect to the 20% fee charged for legal services? Yes X.

2. If you have answered question no. 1 "Yes," then answer this question: Was such breach a direct cause of damage to Tudor Oaks Condominium Project, an Ontario Limited Partnership? Yes X.

3. Did Mr. Cochrane breach a fiduciary duty to Tudor Oaks Condominium Project, an Ontario Limited Partnership with respect to the relinquishment on December 16, 1966 of the 20% "carried interest"?. Yes X.

Appendix A

4. If you have answered Question no. 3 "Yes," then answer this question: Was said breach a direct cause of damage to Tudor Oaks Condominium Project, an Ontario Limited Partnership? Yes X.

5. Did Mr. Cochrane breach a fiduciary duty to Tudor Oaks Condominium Project, an Ontario Limited Partnership by his purchase personally of fifteen (15%) percent interest in the Sheriff's Certificate of Sale? Yes X.

6. If you have answered Question no. 5 "Yes," then answer this question: Was such breach a direct cause of damage to Tudor Oaks Condominium Project, an Ontario Limited Partnership? Yes X.

7. If you have answered Questions nos. 2, 4, and/or 6 "Yes", then answer this question: What sum of money will fairly and adequately compensate Tudor Oaks Condominium Project, an Ontario Limited Partnership for any loss it sustained as a result of said breach or breaches? $1.628 million.

8. Did KSCS, Inc. and John Cochrane conspire to breach Mr. Cochrane's fiduciary duties to Tudor Oaks Condominium Project, an Ontario Limited partnership? Yes X.

9. If you have answered Question no. 8 "Yes," then answer this question: Was said conspiracy a direct cause of damage to Tudor Oaks Condominium project, an Ontario Limited Partnership? Yes X.

10. What sum of money will fairly and adequately compensate Tudor Oaks Condominium Project, an Ontario Limited Partnership for any loss it sustained as a direct result of said conspiracy? $3.52 million.

Appendix A

11. What was the fair market value on December 17, 1986 of 100% of the interest in the Sheriff's Certificate of Sale that was purchased by KSCS? $5.6 million.

12. Did Mr. Cochrane have a fiduciary duty to S.B. McLaughlin & Company, Ltd., by reason of his representation of Tudor Oaks Condominium Project, an Ontario Limited Partnership? Yes X.

13. If you have answered Question no. 12 "Yes," then answer this question: Did Mr. Cochrane breach said fiduciary duty to S.B. McLaughlin & Company, Ltd.? Yes X.

14. If you have answered Question no. 13 "Yes," then answer this question: Was said breach a direct cause of damage to S.B. McLaughlin & Company, Ltd.? Yes X.

15. What sum of money will fairly and adequately compensate S.B. McLaughlin & Company, Ltd. for any loss it sustained as a result of said breach? $792,000.

THE FOREPERSON:

By: s/ illegible

Time: 11:20 am
Date: illegible

* * *